Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category

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(Standard disclaimer applies)
Do we understand enough?

- “When we understand how to distinguish well enough between predatory and legitimate lending, probably a federal statute would be a good idea.”
  - Chairman Ben Bernanke, Feb. 15, 2007

- Results suggest we do not yet understand enough
  - Caution warranted on *national* restrictions on particular loan features.
Some questions we need answered:

- What is the relationship between predatory loan features and the probability of foreclosure?
- Does the relationship vary according to loan category?
- Do combinations of loan features impact foreclosures differently than single features?
- Is the relationship consistent across subprime markets nationwide?
Data

- LoanPerformance subprime data for Chicago
  - 1999QI-2003QII
  - 31,300 loans, over 200,000 loan-quarter observations

- Predatory loan features under study:
  - Long (> 3 years) prepayment penalty period
  - Balloon payment
  - Low- or no-documentation
Change in probability of foreclosure relative to a loan with no predatory features – Refinance FRMs

- Long Prepayment Period: -38%
- Balloon Payment: +78%
- Low/No Documentation: +54%
- Prepay + Balloon: +52%
- Prepay + LowNoDoc: +227%
- Balloon + LowNoDoc: +66%
- All Three PLPs: +108%
Change in probability of foreclosure relative to a loan with no predatory features – **Purchase FRMs**

- Long Prepayment Period: +3%
- Balloon Payment: +1%
- Low/No Documentation: -15%
- Prepay + Balloon: +78%
- Prepay + LowNoDoc: -54%
- Balloon + LowNoDoc: -47%
- All Three PLPs: +20%
Change in probability of foreclosure relative to a loan with no predatory features – *Refinance ARMs*

- Long Prepayment Period: +16%
- Balloon Payment: ----
- Low/No Documentation: +21%
- Prepay + Balloon: ----
- Prepay + LowNoDoc: +22%
- Balloon + LowNoDoc: ----
- All Three PLPs: ----
Change in probability of foreclosure relative to a loan with no predatory features – *Purchase ARMs*

- Long Prepayment Period: +0.4%
- Balloon Payment: ----
- Low/No Documentation: -4%
- Prepay + Balloon: ----
- Prepay + LowNoDoc: +20%
- Balloon + LowNoDoc: ----
- All Three PLPs: ----
Results and policy implications

- Impact of a predatory feature on subprime foreclosures:
  - Highly dependent on loan category
  - Highly dependent on presence of other features

- Subprime market appears segmented along multiple lines, in ways not clearly understood

- Broad-brush regulation likely too blunt a policy tool
  - May eliminate potentially valuable contractual possibilities that in many cases do not seem problematic

- Regulation that does not differentiate among loan categories will be especially prone to causing unwelcome distortions
Caveats

- Analysis does not address equity stripping
  - Quantitative data not available
  - No compelling reason why complex effects on foreclosures would not apply to equity stripping

- Data from Chicago only
  - Problematic for *national* policy implications if:
    - Relationship between predatory features and subprime foreclosures is generally consistent nationwide, and
    - Chicago is somehow anomalous
Conclusions

- We do not yet know enough to confidently craft effective national anti-predatory lending regulation

- Recommend continued development of state and municipal regulation
  - More tailored to local market circumstances
  - Generate greater knowledge of what works